IMPACT OF THE FINANCIAL CRISIS UPON EASTERN EUROPE COUNTRIES: STILL A PROBLEM FOR THE ECONOMY OF THE REGION?

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Abstract
The paper looks at the impact of the global economic and financial crisis on a number of central, eastern and south-eastern European countries. The global crisis can be viewed as three interdependent and mutually reinforcing crises: a financial crisis, a liquidity crisis, and a crisis in the real economy. The financial crises that have emerged and developed in the recent decades have been characterized, mostly of an international dimension, with shocks quickly propagating through capital markets, through the international banking activities and, through the money markets.East Europe was hit first by the global liquidity crisis, then by declines in capital inflows and plunging demand for their exports.Before the crisis, the Eastern region was experiencing an economic boom with rapid GDP and credit growth, but in the future East European countries will have to rely relatively more on internally-generated sources of productivity growth.

Keywords: *financial crisis; capital flows; Central and Eastern Europe; crisis; EU; EE; recession, causes, policies, remedial measures.*

Introduction

The crisis has not stopped to the U.S. economy, but also propagated to Europe as well, the first country affected by events in the U.S. being the UK, with problems of Northern Rock, which caused a panic among bank depositors. In an overview, we can say that the current crisis has initially propagated only to developed countries, particularly through the acquisition by European banks of derivative products backed by subprime mortgages, as well as through the increasing market for securities backed by assets. Initially emerging countries have avoided a crisis, maybe due precautions taken following the Asian crisis. But, when the crisis began to affect the real sector, emerging countries have also started to be affected through the trade links with developed economies. Also, through the presence of international financial institutions in these countries, the problems suffered by it in the parent country have passed on to the activities in emerging countries.The EU wants the establishment of a centralized financial supervision; while officials from several countries require the application of more effective and accurate risk management practices. Implementing a more robust set of regulations regarding capital adequacy, strengthening liquidity management practices, improving the standards of risk classification and protection against them and, last but not least, creating a new global financial system, now represent, beyond any doubt, unquestioned needs.[1]

The impact of the crisis in Eastern Europe

Until fall 2008, the Eastern European countries had enjoyed a wonderful decade, with an average growth rate for the whole region of 7–8 percent a year thanks to three factors. First, in the 1990's these countries had undergone a successful transition to market economies, with deregulation,

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[1] DubravkoMihaljek, "The spread of the financial crisis to central and eastern Europe: evidence from the BIS data", 2009

privatization, and financial stabilization. Second, they benefited from vast underutilized real and human capital. Third, their exports drove growth through international integration and a global boom.

Eastern Europe was making one classical policy mistake. Many countries had fixed exchange rates, notably Estonia, Latvia, Lithuania, Belarus, Russia, Ukraine, and Bulgaria. The illusory safety of the pegged exchange rate attracted large inflows of short-term lending from European banks. The currency inflows boosted the money supply, and inflation surged with money supply growth from 2006. The inflation was worst in Ukraine.

The temptation for international banks was irresistible. They could lend to consumers in Ukraine for 50 percent per annum with minimal financing costs. But this was a dangerous speculative scheme. The foreign exchange inflows accelerated imports and boosted balance of payments deficits. High inflation priced countries with fixed exchange rates out of the market.

The unprecedented global boom had left the IMF dormant, but it quickly woke up and agreed on new stand-by agreements for Ukraine, Hungary, and Latvia. Other countries with new IMF agreements are Georgia, Belarus, Serbia, and Romania.

The Eastern European financial crisis of 2008–09 resembles the East Asian crisis of 1997–98. The fundamental problem then and now was excessive inflows of short-term bank credits, enticed by pegged exchange rates, leading to large private foreign debt. Public finances, by contrast, were mostly in excellent shape with the exceptions of Hungary and Romania, which had significant budget deficits, but only Hungary had a worrisome public debt.

The domestic vulnerabilities were aggravated by the worst financial panic of our lifetime. Capital fled to the perceived safe havens: gold, the dollar, the euro, the yen, and the Swiss Franc. Even the British pound and the Swedish krona plummeted. A financial panic is a market failure that needs to be cured by the state, and internationally the IMF is supposed to provide countervailing financial flows.

The IMF acted fast and well. In the East Asian crisis, the IMF was perceived as excessively intrusive, adding many demands for structural reforms to its traditional agenda. This time, the IMF returned to the more elementary Washington Consensus cure of the early 1990s. Essentially, the IMF posed three demands: a budget close to balance, a realistic exchange rate policy, and bank restructuring with recapitalization. In return for the fulfillment of these conditions, the IMF offered far larger loans than previously.Exchange rate policy has become the bone of contention in the new stabilization programs. If a country devalues, its banks could be squeezed on all sides. The local cost of the loans the banks had taken abroad would sharply rise, and many would default. Their domestic customers that had taken loans in foreign currency would also be unable to repay them with revenues in the devalued currency.[2]

Hungary and Romania had floating exchange rates, which plunged along with the floating rates of other currencies not facing a crisis, such as Poland and the Czech Republic. The IMF forced Ukraine to float and Belarus to devalue, but the Baltic states offered a stumbling block. They have long tied their currencies to the euro, in hopes of adopting the euro as early as 2006 hopes that were frustrated by the rising inflation rates that took hold during 2007–08. As Latvia still aspires to join the euro in 2012, it opposes any devaluation.

The European Union's decision earlier not to provide a massive, 180 billion euro bailout to Eastern European banks made headlines around the world. But that doesn't mean the richer nations of the Eurozone have abandoned their poorer neighbors to the east. Instead of handing over billions to bankers who made terribly poor decisions, as the U.S. Treasury has done in America, each bailout will be considered on a case-by-case basis, and each will be subject to strict "conditionalities" similar to those imposed in any IMF agreement. Next, the graphics that I will present will show us the growth of GVA by sector at the European level in order to show us the importance of financial

[2] See Peter Haiss, Andreas Paulhart and Wolfgang Rainer, “Do foreign banks drive foreign currency lending in Central and Eastern Europe?”, 2009

fluctuation in the European economy, moreover we will also be able to see the impact of the crisis on GDP growth and GDP per capital on each country that has our interest in the analyses that has been proposed.

Nevertheless, during recession in 2008/2009 the contribution of households to value added growth fell, and in fact turned negative from the final quarter of 2008. While positive growth rates were recorded each and every quarter until the middle of 2008, the negative growth rates in the final quarter of 2008 and the first quarter of 2009 were greater in magnitude than any of the growth rates recorded in earlier years, underlying the severity of the recession. In fact these were the first negative rates of change since the series began in 1995 and it is widely acknowledged that this is the worst global recession since the 1930's.[3]

More detailed insights on trends affecting different types of economic agents during the recession can be gained from the sector accounts. Figures indicate the contribution of the institutional sectors to changes in value added, capital formation, and lending/borrowing. Non-financial corporations generally deliver the largest contribution to value added (and GDP) growth, but their contribution is quite volatile. The contribution of households normally fluctuates less, partly because of the stabilising influence of the imputed rent on owner occupied dwellings.

REGIONAL INDICATORS

South Eastern Europe Indicators	2008	2009	2010f	2011f
GDP, US$bn [1,3]	990	855	983	1,122
Real GDP growth, % [2,3]	1.7	-4.6	5.0	4.3
Inflation, eop, % [2,3]	9.9	5.3	7.9	7.4
Exports, US$bn [1,3]	231.5	177.1	183.2	198.6
Imports, US$bn [1,3]	343.3	237.6	260.2	288.1
Trade balance, US$bn [1,3]	-111.8	-60.6	-77.0	-89.4
Current account, US$bn [1,3]	-77.5	-26.5	-42.8	-54.3
Current account, % of regional GDP [1,3]	-7.8	-3.1	-4.4	-4.8

Source: http://www.emergingeuropemonitor.com

This regional indicators show us on a horizont of time how the inflation,exports, imports or trade balance influenced the south-eastern Europe, this is to say that between 2008-2011 this economic indicators show us the fact that a slight amelioration can be seen at the average of this perioud but compared to other western countries, shown also by the table of content 16, the south eastern region of europe couped more difficult with the crisis, its negative effect can be evalued also during 2010 and 2011 when the real GDP growth is seemingly come to arises.With baby steps the eastern economy begins to recover.This does not mean Europe is now being divided between east and west along old lines. On the contrary, countries like the Czech Republic, Slovenia and Slovakia, which have pursued sane and sober economic policies, are just as opposed as Germany to bailing out the likes of profligate Hungary, Latvia, Romania and the Baltic states. Key EU leaders were simply not prepared to provide a blanket handout to those EU countries that got themselves into deep trouble through the siren call of excessive credit. As a result, 50% of household debt is now in foreign currency in Hungary; 30%-40% in Poland and Romania; and over 70% in the Baltic states.There's little doubt that Eastern Europe's credit crunch will ricochet back into Western Europe. Most Eastern Europe banking systems are dominated by Western European banks. Austria is most vulnerable,

[3] http://epp.eurostat.ec.europa.eu/portal/page/portal/product_details/publication?p_product_code=KS-CD-10-220

since the Eastern European exposure of its banks is about 80% of the country's GDP. Losses for Austrian banks could run as high as 10% of GDP, or over 25% of Austrian bank capital.[4]

On the other side of the imbalances were European banks from Swedbankin the Baltics to Erste Bank, Raiffeisen, Unicredit and KBC in the rest of Europe economies. Interestingly, for EE economies such high level of internationalization meant both that prior to the crisis the building up of the fragility in the system was very fast and, on the other hand, with the crisis actually happening, the high share of foreign ownership in EE banking sector played a stabilizing factor via stemming the reversal of cross-border financial flows. In fact, the latter aspect seems to have saved most EE economies, notably the Baltic countries, from outright default and run to the banks and currencies. However, it can be argued that both the increase in domestic foreign currency borrowing and development of the banking sector in 2000's represented in essence a massive carry trade with EE households and companies receiving both interest rate and currency risks in form of long term debt.

This mix created economic environment that is automatically both very procyclical and somewhat allergic to governments meddling with the markets at the same time. Accordingly, the response to the crisis has been relatively slow in Eastern Europe economies. Yet, as the built-up and cumulative imbalances cannot simply vanish, they are being transformed into other forms of risks and imbalances: either increasing public debt or unemployment, or both. EE economies with floating exchange rates regimes have experienced devaluation of their currencies, the Baltic economies on the other hand are crippled by rapid drops in real wages (more than -5% in 2009).Without the money transfers of International Monetary Found almost all EE countries would face public deficits (or much worse unemployment figures) close to double digits, that is very much like Greece with its 12-13% public deficit in 2009 (Greece receives EU transfers as well). In essence, the EU fiscal transfers allow EE countries, in particularly those with most massive imbalances, export some of the accumulated imbalances back into the EU and in addition attempt to free-ride on stimulus packages enacted in rest of the EU.[5]

In order to resume what happened to the Eastern Europe economy during the crisis and the main features of this one for the eastern economic level I will point out three important characteristics of the crisis taking into account some affinities with the Asian crisis of the years '98. First, while EE and other key developing countries experienced an exhilarating rise in FDI and exports, there is a stunningly obvious divergence in income growth between Asian economies, on the one hand, and economies on the other hand.Eastern Europe economies have struggled throughout the last decades to stay above the 1980 level.second, rapid deindustrialization and primitivization of industrial enterprises or even the outright destruction of many previously well-known and successful companies.

Second, rapid deindustrialization and primitivization of industrial enterprises or even the outright destruction of many previously well-known and successful companies. This happened because of the way Soviet industrial companies, and the industry in general, were built up and ran in a complex cluster-like web of planning and competition. A sudden opening of the markets and abolition of capital controls made these industrial companies extremely vulnerable. The partially extreme vertical integration that was the norm in such companies meant that if one part of the value chain ran into problems due to the rapid liberalization, it easily brought down the entire chain. However, foreign companies seeking to privatize plants were almost always interested in only part of the value-chain.

Third, such a drastic change made it relatively easy to actually replace Soviet industry: with the macroeconomic stability and liberalization of markets, followed by a rapid drop in wages, many former Soviet economies became increasingly attractive as privatization targets and outsourcing of

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[4] http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp114.pdf

[5] "Financial Crisis in Central and Eastern Europe"-Reiner Katel, Tallin University of Technology, Estonia,2010

production. Indeed, one of the most fundamental characteristics of Eastern Europe industry since 1990 has been that the majority of companies have actually engaged in process innovation.

In the end of this paper I would want to conclude something about the measures or iniatives that the eastern Europe has had until now in order to diminish the impact of the economic crisis upon their national economies. Nevertheless,it is interesting to be seen if this measures can be upholded and sustained by all Eastern European countries but this could be the subject of an another heated debate because the differences between the eastern European countries is an interesting subject.The policy response to the crisis in the EE countries focused on standard and non-standard monetary policy action as well as fiscal measures. Standard monetary policy remained very cautious in most countries until the end of 2008 when the severity of the recession became clear and most EE countries embarked on a process of monetary easing. In most EE countries, however, policy rates remain at higher levels than in major industrialised economies. Fiscal policy responses to the crisis varied within the region and were mainly determined by the fiscal situation at the beginning of the crisis. Overall, the various national and international support measures appear to have helped to cushion the impact of the global economic and financial crisis on the EE countries.

Conclusions

The global economic and financial crisis affected the EE region through various channels of transmission. Although the schematic depiction below is not exhaustive and there might be overlaps and feedback loops between the various channels, it provides a good starting point for analysing the spillovers of the global crisis to EE. In addition, one should bear in mind possible second-round effects of spillovers from affected emerging economies to developed countries and/or spillovers among emerging economies. In general, there are three financial transmission channels through which the global crisis may affect the EE region: direct and indirect channels, as well as second-round effects. The direct channel works mainly via changes in the prices of toxic assets in the portfolios of financial institutions. The indirect financial channels, which become important once there is a deterioration of foreign investor sentiment towards emerging markets, relate to asset prices, money and debt markets as well as capital flows. In this regard, the first two channels explain price effects, while the third one refers to volume effects. Looking in more detail at the indirect financial transmission channels, a loss of investor confidence can hit the EE region first via foreign exchange, stock and real estate. The policy response to the crisis focused in the EE countries on standard and non-standardmonetary policy action, as well as fiscal measures. In countries with flexible exchange rates, key interest rates were lowered as from the end of 2008 when the severity of the recession became clear.

Thus, it should not come as a great surprise that EE countries became the epicenter for the global financial crisis. On the contrary, EE experiences in the last two decades seem to epitomize the problems created during these years globally. On the one hand, there is the fast and furious industrial restructuring driven by massive inflow of FDI; the rise of modularity in production means that large parts of restructured industry are oriented towards lower value added activities with low domestic linkages. On the other hand, equally transformative change in the banking sector essentially breaks the ties with domestic productive sector only to marry with help of enormous inflow of cross-border lending with domestic consumers. This led to loss of competitiveness through low productivity growth and through currency appreciations. All of this is accompanied by fragmented and hollowed out policy arena incapable of creating structural and innovation policies to further productivity growth. Fiscal transfers from the EU are to remain highly important for all EE economies, yet without significant enhancement in policy capacity, EE economies will simply free-ride on EU transfers and stimulus programs and postpone much needed industrial policies even further into the future. This way, however, EE threatens to become a real burden on EU's competitiveness.

Fiscal policy responses to the crisis varied within the region and were mainly determined by the fiscal situation at the beginning of the crisis. Overall, the various national and international support measures appear to have helped to cushion the impact of the global economic and financial crisis on the EE countries and the region's integration into European banking networks turned out to be, on balance, an asset during the crisis (although it also played a role in fuelling the boom before the crisis). The EU anchor also provides a functioning institutional and regulatory framework forEE countries that promotes the convergence process and is expected to prevent extreme policy slippages.

The disruptions in domestic and international financial markets, together with the real transmission channels such as the plunge in global trade flows, had a pronounced effect on real economic developments since late 2008, ultimately resulting in severe recessions in most countries in the region. Future domestic demand will dependinteraliaon the success of private debt restructuring and the willingness of the financial sector to continue lending. This is to say that the financial crisis hit hard the Eastern Europe countries because their developing economy and financial instability, on the other hand their dependence on outside financial incomes has increased their budgetary balance and during this following years will see how the return of this debt will affect or not their future development. Needless to say that the effect of crisis in the eastern Europe has had different effects on the countries in this region, more effected being the south-east countries as Greece, Bulgaria, Ukcraine and Romania were the economic collapse and the ending of crisis has had a more large horizont of time and the governamental measures were more severe due to the lack of financial stability and also due to the fact that competitiveness of governments is still a subject open to argue about.

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